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IN THE

Supreme Court of the United States

OCTOBER TERM, 1958.

No. 880

ROBERT F. ZEDDIES,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

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INDEX

	PAGE
Jurisdiction	2
Questions presented	2
Statutes involved	3
Statement	4
Reasons why the writ should be granted	10
Conclusion	17
Appendix A	
Opinion below	1a
Judgment below	11a
Order denying petition for rehearing	12a
Appendix B	
Statutes	13a

CITATIONS.

CASES:

A. & A. Tool & Supply Co. et al v. Commissioner, 182 Fed. 2d 300	12
Cohan v. Commissioner, 39 Fed. 2d 549	2, 7, 11, 12, 13, 14, 17
Davis v. Commissioner, 184 Fed. 2d 86	13
Drieborg v. Commissioner, 225 Fed. 2d 216	13
Durkee v. Commissioner, 162 Fed. 2d 184	7, 10
Federal National Bank of Shawnee v. Commissioner, 180 Fed. 2d 494	7, 10
Gaspar v. Commissioner, 225 Fed. 2d 284	7, 10
Helvering v. Taylor, 293 U.S. 507	2, 7, 9, 10, 12, 17
Industrial Trust Co. v. Commissioner, 165 Fed. 2d 142	7, 10
Peurifoy v. Commissioner, 358 U.S. 59	14

PAGE

Phillips Est. v. Commissioner, 246 Fed. 2d 209 10

Rogers v. Commissioner, 15 T.C.M. 890, aff. 248 Fed. 2d 452 11

STATUTES:

Internal Revenue Code of 1939, Secs. 54, 275, 293 ..... 13a

Internal Revenue Code of 1954, Secs. 74, 54 ..... 14a

REGULATIONS CITED:

Regulation 111, Sec. 29.54-1 as amended, T.D. 5381, June 26, 1944 9

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Robert F. Zeddies, petitioner, prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Seventh Circuit entered in the above entitled case on February 20, 1959.

CITATIONS TO OPINION BELOW.

The memorandum findings of fact and opinion of the Tax Court (App. Vol. 1, p. 228) is reported unofficially in 17 T.C.M. 63. The opinion of the Court of Appeals printed in Appendix A hereto, *infra*, p. 1a, is not yet reported.

JURISDICTION.

The judgment of the Court of Appeals was entered on February 20, 1959. Appendix A, *infra*, p. 11a. Rehearing was denied on March 30, 1959 Appendix A, *infra*, p. 12a. The jurisdiction of this Court is invoked under 28 U.S.C. §§ 1254(1) and 2101(c).

QUESTIONS PRESENTED.

1. Whether the Court of Appeals erred in holding that petitioner did not establish the invalidity of respondent's determination under the rule in *Helvering* v. *Taylor*, 293 U.S. 507, 513-514, petitioner having shown (a) that the candy suppliers upon whose records respondent relied in reconstructing petitioner's cost of goods sold at so-called ceiling prices were unworthy of belief and that their records were false; (b) that petitioner's costs of goods sold were substantially in excess of ceiling prices; (c) that respondent knew that the formula upon which he based his determination that petitioner had unreported profits from the sale of candy was contrary to prevailing market conditions and contrary to the facts and knew that petitioner was entitled to include over ceiling payments in determining his cost of goods sold; (d) that respondent knew that petitioner was employed by Kroger Grocery & Baking Co. on a commission basis to procure candy obtainable only at over ceiling prices; (e) that his employment required petitioner to purchase candy with his own funds for which he was reimbursed and paid commissions; (f) that petitioner was not entitled to profits in addition to commissions and Kroger Buyers were satisfied that petitioner issued invoices at his actual cost and no more; (g) that the purpose of such employment was to enable Kroger (1) to obtain candy obtainable only at over ceiling prices without being a direct party to black

market transactions, and (2) to receive invoices at its actual cost upon which to base its retail price within the so-called ceiling price which invoices were not otherwise available from candy manufacturers that charged over ceiling prices; (h) that invoices furnished respondent by one William A. Schmeckebier, a buyer of inferior candy, and purporting to have been issued by petitioner were false.

2. Whether the Court of Appeals properly sustained the Tax Court's findings of fraud which were based upon the presumption of correctness of the determination and not supported by evidence.

3. Whether the rule in *Cohan* v. *Commissioner*, 39 Fed. 2d 540 permits the Tax Court to make estimates of cost of goods sold, a factor in determining the existence of income.

4. Whether the rule in *Cohan* v. *Commissioner*, 39 Fed. 2d 540 permits the Tax Court to make estimates either of cost of goods sold or business expenses in disregard of the evidence.

5. Whether the Court of Appeals' determination that the findings of the Tax Court were supported by substantial evidence was based upon a fair assessment of the record.

STATUTES INVOLVED.

The statutory provisions involved are Section 54 (a), 275, 293 of the Internal Revenue Code of 1939, 26 U.S.C. 1952, Sec. 54, 275, 293; Section 7454 of the Internal Revenue Code of 1954, 26 U.S.C. 1952 ed., Supp. II, Sec. 7454. They are printed in Appendix B hereto, *infra* p. 13a.

STATEMENT.

Petitioner filed a petition for review of a deficiency and penalty determination dated January 11, 1955, concerning the years 1942 through 1947 in the Tax Court of the United States on April 7, 1955. (App. Vol. I, p. 4.) The jurisdiction of the Tax Court was invoked to set aside the deficiency and penalty determination, and to have the Tax Court determine that there was no deficiency in income tax due by petitioner for any of said years and that the Commissioner erroneously imposed a fraud penalty. The jurisdiction of the Tax Court is sustained under Title 26 U.S.C., Secs. 6213(a), 7442, 7453. Respondent filed an answer generally denying the allegations in the petition and alleging fraud (App. Vol I p. 24). Petitioner filed a reply denying fraud (App. Vol. I, p. 31). After hearings the Tax Court entered its memorandum findings of fact and opinion on January 31, 1958, sustaining the determination with adjustments for all of the years except the years 1942 and 1943, as to which respondent conceded that there was no fraud and that assessments for those years were accordingly barred by the statute of limitations and finding fraud with respect to each of the remaining years (App. Vol. I p. 227). A motion for reconsideration was filed and denied on March 17, 1958 (App. Vol. I p. 252). The Tax Court entered its decision pursuant to Rule 50 of the Tax Court rules on March 27, 1958 (App. Vol. I, p. 260). Petition for review by the United States Court of Appeals for the Seventh Circuit was filed June 20, 1958 (App. Vol. I, p. 3, 261). On February 20, 1959 the Court of Appeals affirmed the decision of the Tax Court (App. A, *infra p.* 11a). A petition for rehearing was denied on March 30, 1959 (App. A, *infra*, p. 12a).

At issue in the Tax Court and in the Court of Appeals was the validity of respondent's determination and the existence of fraud. (App. Vol. I p. 203). Petitioner's contention was that the determination was invalid, that the determination was arbitrary and erroneous, that the formula upon which it was based could not produce the correct result, that the determination should have been set aside and that the respondent's findings of fraud were erroneous (App. A, *infra*, p. 2a, 9a).

Respondent's determination assumed that petitioner was an independent candy jobber who had income from the purchase and sale of candy which he did not report; that the difference between amounts shown on the records of candy manufacturers (their records showing sales to petitioner at manufacturers' OPA ceiling prices) and amounts shown on records of persons and firms purchasing candy from petitioner, principally Kroger and concerns packaging bulk candy for Kroger (the records of sales by petitioner being unquestioned by petitioner with the exception of sales to one William A. Schmeckebier) represented unreported income. (App. Vol. I, pp. 5, 115, 116, 150, 171, 206; App. Vol. II, p. 100a).

Respondent also determined that petitioner received commissions under the guise of fictitious sales of candy which were not reported (App. Vol. I p. 39, App. Vol. II, p. 101), that petitioner was a partner in a packaging firm and failed to report his share of the profits or loss of the partnership as determined (App. Vol. I, pp. 17, 18), and that petitioner had overstated claimed business expenses in substantial amounts for each year (App. Vol. I, pp. 16-17).

Petitioner claimed that he was not an independent candy jobber engaged in the business of buying and selling candy for profit but that he was employed by the Kroger Grocery and Baking Company to procure candy from candy manufacturers obtainable only at over ceiling prices (App. Vol. I, pp. 6-12, 42-43, 244); that pursuant to such employment he consulted with Kroger buyers, then purchased candy in his own name (App. Vol. I, pp. 41-43, 55-56, 65, 78, 79, 121-123, 231), paying ceiling prices by check and additional amounts by cash or ingredients used in the manufacture of candy; that he then issued invoices in his own name, or a trade name to Kroger or firms which packaged bulk candy for Kroger at his actual costs (App. Vol. I, pp. 56, 122-123) and received as his compensation commissions which were reported (App. Vol. I, pp. 52, 62, 63, 65, 139); that on occasion, in order to get candy for Kroger, he had to take inferior candy from the candy manufacturers in a tied-in arrangement and that such candy was unfit for Kroger use and was traded by him for lesser amounts of candy which could be used by Kroger (App. Vol. I, pp. 79, 142); that under his employment contract he was obliged to buy back from Kroger, candy which was spoiled or was out of season; that such candy was repurchased at Kroger's cost if still in Kroger warehouses or at Kroger's retail prices if in its retail stores; that such inferior candy was used as an inventory for trading purposes, or sold at a loss or thrown out although there were some occasions when he did succeed in selling such candy at a profit which minimized his over all losses (App. Vol. I, pp. 40, 45-53, 62-63, 70, 79, 83-84, 110, 113, 142-143); that there were a few small transactions in which he received a profit instead of a commission (App. Vol. I, pp. 39, 53, 59).

The Tax Court found that petitioner was employed as claimed (App. Vol. I, pp. 230-231), but rejected his claim

that he was not buying candy for profit *in addition to* commissions inasmuch as he sold the inferior candy which he was required to take back from Kroger for his own account (albeit at a loss) and one of his witnesses testified that there were some small transactions in which petitioner actually received a profit instead of a commission (App. Vol. I, p. 241). Respondent offered the testimony of candy manufacturers who testified that their records showing sales to petitioner at ceiling prices were correct (App. Vol. I, pp. 152-153, 156, 158, 159). The Tax Court found that their testimony was unworthy of belief and that petitioner was required to pay over ceiling prices for candy (App. Vol. I, pp. 230-234, 245, 247). Petitioner's claims were otherwise uncontroverted and were supported by substantial evidence.

The Tax Court said: "It does not follow, however, that all of petitioner's claims are valid. The record reveals a glaring lack of documentation of the over ceiling payments testified to by petitioner and other witnesses. No records of these transactions were introduced in evidence, except for a few of petitioner's cancelled checks bearing self-serving notations such as 'expense' and 'overage'. Petitioner's own recollections of these instances was hazy and the testimony of his corroborating witnesses did not supply the missing details." (App. Vol. I, p. 246). The Tax Court did not mention petitioner's contention that his burden was simply to establish the invalidity of the determination under the rule in *Helvering* v. *Taylor*, 293 U.S. 507, *Gasper* v. *Commissioner*, 225 Fed. 2d 284, at 288; *Industrial Trust Co.* v. *Commissioner*, 165 Fed. 2d 142, at 148; *Burkee* v. *Commissioner*, 162 Fed. 2d 184 at 187; *Federal National Bank of Shawnee* v. *Commissioner*, 180 Fed. 2d 494, at 497.

The Tax Court purportedly pursuant to the rule in *Cohan* v. *Commissioner*, 39 Fed. 2d 540, determined that

petitioner paid amounts in excess of ceiling prices of $2000, $20,000, $40,000 and $10,000 for the years 1944 through 1947 respectively; and accordingly reduced respondent's determination of profits by such amounts (App. Vol. I, pp. 234, 247).

Petitioner claimed that he reported all commissions received (App. Vol. I, p. 139). There was no evidence that petitioner did not report substantially all commissions received. Respondent conceded that petitioner reported substantially all commissions received as such (App. Vol. I, p. 39). The Tax Court sustained an amended determination as to unreported commissions (App. Vol. I, pp. 232, 240).

Respondent's evidence of partnership income for 1945 and 1946 and the partnership loss for 1947 was substantially different from his determination (App. Vol. I, pp. 166-167, 235; App. Vol. II, pp. 112, 116, 120). Petitioner claimed that he was a trustee for his children in the partnership, having invested their money (App. Vol. I, pp. 11, 132). His testimony to this effect was uncontroverted. There was testimony that money paid to him by the partnership was used in connection with the employment by Kroger (App. Vol. I, p. 138). The Tax Court held that petitioner's claim was false and sustained respondent's determination as to unreported partnership income (App. Vol. I, p. 235).

The Tax Court found that at least part of the deficiency for each of the years 1944 through 1947 was due to fraud with intent to evade tax (App. Vol. I, pp. 239, 251). It based its findings of fraud (a) on petitioner's failure to report profits from the sale of candy which by virtue of respondent's determination were presumed to have been received; (b) his presumed understatement of commissions, his failure to report income from the part-

nership in 1945, 1946 and 1947 which was presumed only as to 1945 and 1946, respondent's determination as to a loss in 1947 having been sustained; (d) petitioner's claim that he was a trustee for his children with respect to the partnership; (e) findings that petitioner refused to cooperate with internal revenue agents and (f) the inadequacy of petitioner's records (App. Vol. I, pp. 237-238, 251). The Tax Court did not make findings concerning the reasons for the inadequacy of the records and did not refer to Regulation 111, Sec. 29.54-1 as amended by T.D. 5381, June 26, 1944, which excepted from the requirement that records be kept, including inventories, those persons whose gross income consisted solely of salary, wages or similar compensation for personal services rendered.

In the Court of Appeals petitioner renewed his contention that the Tax Court should have set aside respondent's determination as invalid and could not make "adjustments" as it did without acting contrary to the principle announced in *Helvering v. Taylor*, 293 U.S. 507, 513-514. It was also contended that the Tax Court's findings were contrary to conceded facts, not supported by substantial evidence, were clearly erroneous and in disregard of uncontroverted evidence and absent proof of fraud by clear and convincing evidence for each of the years involved assessment was barred by the statute of limitations, there being no evidence in the record of valid consents signed by petitioner extending the time for assessment for the years involved.

The Court of Appeals summarized the findings of the Tax Court (Appendix A, *infra* pp. 2a-8a), summarily rejected petitioner's contentions (Appendix A, *infra*, pp. 8a-10a), and "finding no error in the disposition of this case by the Tax Court" affirmed its decision (Appendix A, *infra*, p. 10a).

The opinion of the Court of Appeals does not indicate in what manner petitioner failed to establish the invalidity of the determination. It states that petitioner failed to establish that the determination was arbitrary or excessive or based on a formula which could not produce the correct amount of tax due (Appendix A, *infra*, p. 9a).

In rejecting other contentions as unfounded the Court of Appeals stated "it would serve no good purpose to burden this opinion with a detailed statement of these charges". (Appendix A, *infra*, p. 9a).

REASONS WHY THE WRIT SHOULD BE GRANTED.

1. This case involves the important question as to the taxpayer's burden of proof in the Tax Court to establish the invalidity of a deficiency determination by the Commissioner of Internal Revenue.

It is believed that the decision of the Tax Court and of the Court of Appeals below are in conflict with the principle announced by this Court in *Helvering* v. *Taylor*, 293 U.S. 507, 514, 515, and followed by the First Circuit in *Industrial Trust Co.* v. *Commissioner of Internal Revenue*, 165 Fed. 2d 142, the Fifth Circuit in *Phillips Estate* v. *Commissioner of Internal Revenue*, 246 Fed. 2d 209, 214, the Sixth Circuit in *Gaspar* v. *Commissioner of Internal Revenue*, 225 Fed. 2d 284, at 288, and *Durkee* v. *Commissioner of Internal Revenue*, 162 Fed. 2d 184 at 187, and the Tenth Circuit in *Federal National Bank of Shawnee* v. *Commissioner*, 180 Fed. 2d 494 at 497.

Our understanding of the principle of the foregoing cases is that in the Tax Court the taxpayer's burden of proof is to establish the invalidity of the Commissioner's determination and that burden is met by proving that the

determination is arbitrary and excessive or that the formula upon which it is based could not produce correct results. Upon meeting that burden, the taxpayer does not have the burden of proving that he owes no tax or the correct amount of tax that is due.

Although upon petitioner's showing in this case that the determination was based upon false and erroneous records as to petitioner's costs, the foregoing cases would require the Tax Court to make a *redetermination on the basis of* evidence without regard to any presumption of correctness, the Tax Court nevertheless held that "profits" (determined to have been received under the original invalid formula) could be "offset" by amounts which petitioner had the burden of establishing by documentary evidence *in addition to his testimony* and that of his witnesses. Upon holding that petitioner failed to meet such burden the Tax Court offset the determined "profits" for each year by arbitrary amounts said to be arrived at under the rule in *Cohan* v. *Commissioner,* 39 Fed. 2d 549. No basis for the estimate was mentioned and there was evidence that the cost of goods sold exceeded receipts, resulting in no income.

In effect the courts below permitted the presumptive correctness of the determination of profits to survive a demonstration that they were incorrect and substantially excessive and petitioner was held to have the burden of showing the correct amount of tax that was due.

It is believed that it is not open to question that the determination was excessive and that the formula used by respondent could not and did not produce the correct result. In *Rogers* v. *Commissioner of Internal Revenue,* 15 T.C.M. 890 at 894, aff. 248 Fed. 2d 452, relied on by the Court of Appeals, the Tax Court held that a determination that bank deposits represented gross income,

though excessive, absent the taxpayer's cancelled checks or other records, was not arbitrary since it was the only "practical approach" available to respondent. It is believed that the use of false records furnished by third parties with respondent's knowledge that such records showing sales to petitioner at ceiling prices were not in accord with market conditions and facts should never be considered a "practical approach"; otherwise, the Commissioner can manufacture deficiencies out of whole cloth or thin air as a "practical approach".

The maintenance of the integrity of the principle in *Helvering* v. *Taylor*, 293 U.S. 307, is of importance not only in the every day administration of justice in tax cases but for the reason that it prevents the laying of a tax on a part of gross receipts not shown to be income and contrary to the Sixteenth Amendment. The fallacy in the application of the rule in *Cohan* v. *Commissioner of Internal Revenue*, 39 Fed. 2d 540, to this case is that the "profits" from which estimated amounts were subtracted represented presumed income based on the invalid determination. There could be no income unless petitioner's receipts did exceed his cost of goods and his explanation as to why receipts did not exceed cost of goods was reasonable, supported by evidence and uncontradicted.

2. It is believed that the opinion of the Court of Appeals sustaining the Tax Court's findings of fraud, based upon the presumption that petitioner failed to report income, without evidence that there was income, is in conflict in principle with the holding of the Tenth Circuit in *A. & A. Tool & Supply Co. et al* v. *Commissioner*, 182 Fed. 2d 300, that the presumption of correctness is not evidence, and with the Sixth Circuit in *Drieborg* v. *Commissioner of Internal Revenue*, 225 Fed. 216, that the burden is upon the Commissioner to prove *all* of

the elements of fraud; with the Tenth Circuit in *Davis* v. *Commissioner*, 184 Fed. 2d 86, that fraud is never imputed or presumed and courts should not sustain findings of fraud upon circumstances which at the most create only suspicion.

The net result of the Tax Court holding is that petitioner failed to show that he did not have presumed income and that such failure, coupled with his failure to maintain records of such presumed income, and advise the persons who prepared his returns of such presumed income, and his answers to agents that he had no such presumed income, constituted clear and convincing evidence of fraud. The findings of fraud are built upon a house of cards resting upon a presumption.

It is important to the proper administration of justice in tax cases that the statutory burden which Congress has placed upon the Commissioner of Internal Revenue to prove fraud not be held for naught by permitting him to meet his burden through the presumption of correctness.

3. It is believed that the rule in *Cohan* v. *Commissioner*, 39 Fed. 2d 540, cited so often by the courts of appeals for the various circuits needs amplification by this Court to promote the proper administration of justice in tax cases. We understand the rule in the *Cohan* case, as originally envisioned, to be that if a taxpayer shows that he did incur an expense, but cannot show the amount of the expense with certainty, the tax court should estimate such expense from the available evidence in the record and its own experience. It is believed that such rule was intended to be applied where there was a lack of sufficient evidence as to the amount of business expenses which are a matter of legislative grace, but that it was not intended to be applied even then in the face of

uncontroverted evidence. It is believed that the Tax Court in this case disregarded its function of reaching its decision from the evidence and in lieu thereof purported to follow the rule in the *Cohan* case and estimated business expenses as well as cost of goods sold without regard to the evidence in the record. While such procedure may be convenient, it is destructive of the proper administration of justice and in serious derogation of constitutional rights.

4. It is believed that the holding of the Court of Appeals that the findings of the Tax Court were supported by substantial evidence did not result from a fair assessment of the record. See *Peurifoy* v. *Commissioner of Internal Revenue*, 358 U.S. 59, 61.

This may be demonstrated by a reference to some of the findings of the Tax Court. The Tax Court found that a circumstance of fraud was petitioner's failure to advise his accountant Weber of his share of partnership *income* in 1947 (App. Vol. I p. 238), yet sustained the petitioner's determination that there was a partnership *loss* in that year (App. Vol. I p. 235). It relied on petitioner's failure to advise the same accountant of profits from the sale of candy (App. Vol. I p. 238), yet the accountant testified that he made an independent determination and found that there were no profits from the sale of candy (App. Vol. I pp. 64, 65). It relied on petitioner's failure to furnish his lawyer-employee Lampert with documentary support for business expenses claimed (App. Vol. I p. 237) (a not uncommon failing on the part of clients). Yet the witness Lampert testified "there was not too much substantiated evidence. I did have some hotel bills. I asked Mr. Zeddies at great length, 'where did you go last year?' 'Well, I went here, I went there.' And slowly I would draw it out of him until we arrived at how much it would cost to go down

here, how much it would cost to go down there. He kept very poor records—this I readily admit. But at the time—and I had work sheets of a sort to substantiate this—little by little I would draw it out as to what branches we went to—where he went * * * All of the figures claimed are round figures * * * If I had an accurate set of books, a perfect ledger there would be no problem and I could present the ledger at this time. Believe me, this is an honest approach at it. Whether it is to the penny, it isn't. Nor do I feel it is excessive. I wouldn't have been a party to it. This is information that he supplied me with and I acted on that information." (App. Vol. I pp. 91, 92)

The Tax Court found that in 1945 petitioner purchased by check $18,097.43 worth of candy from Peanut Specialty Co., yet the evidence, consisting of paid Peanut Specialty invoices and cancelled checks drawn by petitioner to the order of Peanut Specialty Co. shows that petitioner actually paid that company over $41,000 by check in 1945. (App. Vol. II p. 9). The Tax Court, following respondent's schedules, found that petitioner purchased $134,902.42 by check in candy from Peanut Specialty Co. in 1946, whereas the evidence, consisting of cancelled checks paid to the order of Peanut Specialty Co. in 1946 showed that petitioner paid Peanut Specialty Co. $146,584.53 by check. (App. Vol. II p. 12)

The Court of Appeals states in its opinion: "Taxpayer contends that the Tax Court erroneously determined the nature of his business in finding that he was in the business of buying and selling for his own account. *He claims the evidence shows that his buying and selling activities were in connection with the procurement of candy for Kroger and that he was a 'candy broker'.* There is substantial evidence in the record to support the Tax Court on this issue and such findings are not clearly erroneous." (Emphasis supplied) (Appendix A, *infra*, pp. 8a-9a) It is believed that such statement and finding was not only

clearly erroneous, but it indicates that the Court of Appeals failed to comprehend the fact that the Tax Court expressly found that

> "Kroger hired petitioner to procure candy for its stores through his contacts with candy manufacturers.
>
> "As a Kroger representative, petitioner was assigned a desk at the Kroger office in Chicago and was furnished a stenographer. Otherwise, petitioner bore his own expenses in procuring candy. Kroger paid petitioner a 5% commission on all candy purchased by Kroger through petitioner's efforts.
>
> "Usually, petitioner and Kroger representatives would discuss the type and price of candy that petitioner could obtain. Petitioner would then buy candy from various sources and arrange to have it sold to Kroger in retail units. The price of the candy sold by petitioner to Kroger would include packaging costs and a profit to a packaging company. When petitioner bought candy in bulk, he frequently sold it to East India Nut Company (hereinafter referred to as East India), a packaging concern. East India would pack the candy in retail units and resell it to Kroger. East India paid petitioner a 5% commission on such sales." (App. Vol. I, pp. 230, 231)

and it overlooks the fact that Frank Blakeslee, a former Kroger official whom the Tax Court characterized as a disinterested witness, (App. Vol. I p. 245) testified that petitioner was not permitted to make profits in addition to commissions and that the price which Kroger paid to petitioner represented his actual cost of candy. (App. Vol. I, p. 56).

The Court of Appeals overlooked the fact that there was no evidence that petitioner sold the candy on his own account for profit except as a part of his Kroger employment; that the few instances where he did sell candy at

a profit were in connection with the sale of candy unfit for Kroger use and then only to minimize losses on such candy.

While this Court is, and should be, reluctant to review a judgment involving a review of evidence for the reason that one review should be sufficient, we submit that even a cursory examination of the record in this case will support our claim that the Court of Appeals failed to make a fair assessment of the record.

CONCLUSION.

The courts below have sustained a deficiency determination and fraud penalties of $292,784.44 which, with accumulated interest, must now approach a half million dollars, which, if actually due would make petitioner in our view an arch criminal and an enemy of the society in which he lives. The record below, however, is void of any evidence that petitioner received any of the income upon which such deficiencies could be assessed. Petitioner was never prosecuted for income tax evasion and the customary net worth method of proving income is conspicuously and significantly absent in this case.

We believe that this case is an example of the misapplication of the presumption of correctness and of the rule in *Cohan v. Commissioner*. Reaffirmance of the salutary principle of *Helvering v. Taylor* and the congressionally imposed rule as to burden of proof of fraud is sorely needed.

For all of the foregoing reasons this petition for a writ of certiorari should be granted.

Respectfully submitted,

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G. KENT YOWELL,
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APPENDIX A.

In the
UNITED STATES COURT OF APPEALS
For the Seventh Circuit

No. 12433 SEPTEMBER TERM, 1958—JANUARY SESSION, 1959

ROBERT F. ZEDDIES, *Petitioner,*
v.
COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

Petition for Review of Decision of the Tax Court of the United States.

February 20, 1959

Before DUFFY, *Chief Judge*, MAJOR and HASTINGS, *Circuit Judges*.

HASTINGS, *Circuit Judge*. Petitioner, Robert F. Zeddies (taxpayer), sought, in this action, to set aside deficiencies in federal income tax and fraud penalties determined by respondent, Commissioner of Internal Revenue (Commissioner), for the tax years 1942 through 1947, as follows:

Year	Deficiency	Addition to Tax § 293(b)[1]	
1942	$ 1,358.65	674.33	
1943	7,120.66	4,537.48	
1944	13,696.59	7,798.77	
1945	71,006.44	35,724.67	
1946	137,212.93	68,606.47	
1947	41,301.98	20,650.99	
Total	$271,697.25	$137,992.71	$409,689.96

[1] 26 U.S.C.A. § 293(b) (1939 I.R.C.). Additions for fraud.

At the hearing before the Tax Court of the United States, it was conceded by the Commissioner that the deficiencies for 1942 and 1943 were not due to fraud and that such assessments were accordingly barred by the statute of limitations. As to the other years the Tax Court made specific findings based upon the evidence submitted at the trial and redetermined the deficiencies and penalties as follows:

Year.	Deficiency	Addition to Tax § 293(b)	
1944	$ 10,762.41	$ 6,331.68	
1945	50,983.70	25,713.30	
1946	99,982.40	49,991.20	
1947	32,679.83	16,339.92	
Total	$194,408.34	$98,376.10	$292,784.44

The Tax Court found that at least part of the deficiency for each of the taxable years, 1944 through 1947, was due to fraud with intent to evade payment of tax. Taxpayer's motion for reconsideration was denied and this petition for review followed. Taxpayer contends that the determination of the deficiencies and the findings of fraud are not supported by substantial evidence and are clearly erroneous and that the decision is contrary to law. Since the findings of fact resulting in the Tax Court's determination of the deficiencies and fraud penalties are under direct attack, we shall first summarize them as follows:

Taxpayer's Business

For many years taxpayer was a food broker and salesman in the Chicago area. Most of the time he represented a number of candy manufacturers who sold their products to retail grocery stores, paying his own expenses and receiving commissions for his services. This representation of candy manufacturers continued throughout the taxable period.

During World War II, candy and the ingredients used to manufacture it, primarily sugar and corn syrup, were in short supply. The Office of Price Administration placed ceiling prices on the sale of candy, and sugar and corn

syrup were rationed. The maximum ceiling on candy sold by manufacturers was based on the manufacturer's pre-war price. Retailer's ceiling prices were based on the cost of the candy to the retailer plus a certain percentage of mark-up over cost. Because of these restrictions, some manufacturers of candy established quotas for their customers under which they sold candy to former customers on a percentage of purchases made before the war.

By 1942, Kroger Grocery & Baking Company (Kroger), a retail grocery chain, was one of taxpayer's customers. Kroger had formerly manufactured its own candy for sale in its stores, but the rationing of sugar sharply curtailed this activity; and it was unable to adequately supply its stores. Because it had done little business with candy manufacturers before the war, Kroger had few sources of supply. Kroger employed taxpayer to procure candy for its stores, paying him a commission of five percent on all candy he purchased for them. Kroger furnished him a desk and stenographer in its Chicago office. Otherwise, taxpayer bore his own expenses in procuring candy.

After discussing his sources of supply with Kroger, taxpayer than bought the candy and arranged to have it sold to Kroger in retail units. The price to Kroger included packaging costs and a profit to the packaging company. When taxpayer bought in bulk lots he frequently sold it to East India Nut Company (East India), a packaging concern, which would then pack it in retail units, esell it to Kroger, and pay taxpayer a five per cent commission on such sales.

Commissions

The Tax Court's findings with respect to commissions received by taxpayer during the taxable period were as follows:

Year	Commissions Received	Commissions Reported	Commissions Unreported
1944	$41,061.17	$40,422.70	$ 638.47
1945	45,856.36	43,792.08	2,064.28
1946	79,811.97	57,161.89	22,650.08
1947	48,431.44	38,960.22	9,471.22

Included in the above were commissions from East India of $331.80 in 1944; $1,196.25 in 1945; $10,203.01 in 1946; and 323.23 in 1947. A part of the commissions received in 1946 was the sum of $5,479.82 which had been billed to East India by taxpayer on invoices of Zerna Products Company as sales of chocolate peanuts.

Taxpayer also did business with Kroger through Carol Lynn Products Company (Carol Lynn), a candy packaging partnership in which he owned a one-half interest. Carol Lynn received candy obtained by taxpayer, packaged it, sold it and paid taxpayer commissions of $17,591.76 in 1946 and $9,167.51 in 1947, which are included in the foregoing summary.

Petitioner did not report the commissions received from East India and Carol Lynn on his tax returns, and neither East India nor Carol Lynn reported them by filing Form 1099 with the Commissioner.

Profits from Sales

During the taxable period taxpayer bought bulk candy at wholesale prices from various manufacturers in his own name and as Zerna Products Company, storing it either at East India or in a Chicago warehouse. Taxpayer used his own funds for this purpose and received the proceeds from the sales. He received the invoices from such supplies and issued invoices covering the sales. In conducting this part of the business, taxpayer used an office furnished him free of charge by East India.

Taxpayer kept no formal books and records of the kinds, quantities or costs of candy. He had no bookkeeper to record his business transactions and did not maintain a journal or ledger to record purchases and sales during the taxable years. Part of this candy was spoiled or unsaleable candy, including some he repurchased from Kroger under agreement. Whenever possible, he sold or traded the spoiled and inferior candy, principally to a William Schmeckebier, and sometimes at a profit.

The Tax Court's findings with respect to taxpayer's purchases of candy from suppliers at ceiling prices and his sales of candy to customers during the taxable period (omitting the names of the suppliers and customers) were as follows:

	1944	1945	1946	1947
Purchases	$7,731.73	$97,955.81	$244,905.54	$224,973.94
Sales	13,654.20	155,843.73	363,959.95	265,015.80

In addition to paying the invoice price of candy he purchased, taxpayer made "overceiling" payments to manufacturers and brokers. These payments were "bonuses" in excess of the ceiling price and were made in cash or in ingredients for use in candy manufacturing. The invoices of candy purchased in this manner did not reflect the "bonus" payment but included only the manufacturer's ceiling price. Taxpayer included the "bonus" payment in the price he quoted to his customers for the candy. Kroger, his principal customer, knew that the cost of certain candy to them included overceiling payments but paid the cost without objection in order to get this merchandise.

The Tax Court found that taxpayer made overceiling payments of $2,000 in 1944; $20,000 in 1945; $40,000 in 1946; and $10,000 in 1947, and properly allowed these as part of the cost of goods sold. It then found and determined taxpayer's unreported income from profits from sales of candy during the taxable period to be as follows:

1944	$3,992.47
1945	37,887.92
1946	79,054.41
1947	30,041.86

Partnership Income

On November 1, 1944, taxpayer and Frank W. Brinkman formed a partnership to conduct a candy brokerage business in Chicago which operated under both the names

of Frank W. Brinkman & Associates and Carol Lynn Products Company. Taxpayer advanced initial capital of $5,000, and Brinkman devoted full time to the business. The two partners agreed to share the partnership profits equally.

The partnership tax returns for the taxable years 1945 and 1946 showed taxpayer's share of the net income to be $1,096.30 and $1,433.79, respectively, and in 1947 reflected a loss to taxpayer of $1,945.87. Taxpayer did not report any of this partnership income or loss for any of the years 1945, 1946 or 1947. The Tax Court sustained the Commissioner's redetermination of taxpayer's distributive share of partnership income to be $12,936.08 in 1945 and $6,644.91 in 1946, and his share of partnership loss in 1947 to be $173.97.

Business Expenses

In conducting his business of buying and selling candy, taxpayer incurred losses during the taxable years. These resulted from "slow-moving" and spoiled candy, pilferage and shrinkage reflected in inventory loss, prizes for sales promotions to induce sales by Kroger employees; sales promotions, entertainment of buyers and purchasing agents, traveling expense, and auto expenses. The Tax Court detailed as to each of these items the deductions claimed by taxpayer, the amounts allowed and disallowed by the Commissioner, and the determination it made of the correct amount of each of these expenses for each of the taxable years. Without setting out the various items, the following summary will reflect the totals as determined by the parties and as redetermined by the Tax Court:

Expenses	1944	1945	1946	1947
Claimed by taxpayer	$29,650	$31,989	$37,850	$23,745
Allowed by Commissioner	10,450	9,550	9,150	6,027
Allowed by Tax Court	10,550	10,650	10,250	7,125

Fraud

Taxpayer's income tax returns for the years 1944, 1945 and 1946 were prepared by Lampert, taxpayer's lawyer, on the basis of information furnished by taxpayer. Taxpayer did not furnish Lampert with complete documentary evidence to support the claimed business deductions, did not inform him of the amounts of his distributive share of net income of Frank W. Brinkman & Associates for 1945 and 1946, or of the amount of commissions he received in 1946 from the Carol Lynn partnership. Lampert did not sign the returns he prepared because he did not believe there was sufficient substantiating evidence to support the information contained in them.

Taxpayer's income tax return for 1947 was prepared by Weber, an accountant, on the basis of information supplied by taxpayer. Taxpayer did not furnish Weber any records to support the claimed business deductions, nor did taxpayer inform him of any income from the Carol Lynn partnership in the form of commissions, profits from sales or partnership income.

In 1947, a revenue agent conducted an examination of taxpayer's income tax returns for the years 1944 and 1945. Taxpayer and Lampert were asked to produce petitioner's books and records including bank statements, canceled checks and other documents relating to the years under examination. Taxpayer and Lampert produced no records other than a list of companies that paid taxpayer commissions during the years under investigation. The total commissions listed were the same as the totals listed on the tax returns for 1944 and 1945. Taxpayer informed the agent that he had no income in addition to the commissions reported and that he was not engaged in any business other than as a candy broker.

In 1948, revenue agents made a re-examination of taxpayer's income tax returns for 1944 and 1945 and an original examination of his returns for the years 1946 and 1947. This examination began after leads were obtained during an investigation of Schmeckebier. Taxpayer was again asked to produce the books and records

for the years under examination. The only records produced were records and canceled checks of the partnership, Frank W. Brinkman & Associates, and some of taxpayer's own canceled checks. Taxpayer produced no substantiating evidence to show the purpose for which the checks were issued. Taxpayer did not produce the names of any of his candy suppliers or customers nor did he produce any purchase and sales invoices showing procurement and disposition of candy. Taxpayer did not maintain complete records of all of his sales of candy and did not furnish the agents with documentary evidence substantiating the deductions claimed on his returns. The agents obtained their information as to taxpayer's purchase and sales of candy from the books and records of suppliers and customers of taxpayer, trucking companies and warehouses. From these records, the agents traced shipments of candy from the supplier to taxpayer and then to the ultimate customer. Taxpayer did not furnish the agents with a "workbook" showing all of his purchases and sales of candy during the taxable years.

The Tax Court then found that at least part of the deficiency for each of the taxable years involved here was due to fraud with intent to evade tax.

Taxpayer testified that his initial capital investment of $5,000 to the Brinkman partnership (Carol Lynn) represented money that belonged to his children and thereby sought to establish that they were the owners of the one-half interest attributed to him, claiming in his petition that he held such interest as trustee for their benefit. There is nothing in the record to substantiate this claim except his own unexplained bare assertion. He admitted that his children did not report any gain or loss from the partnership. Brinkman referred only to taxpayer in his testimony. The Tax Court properly sustained the Commissioner on this point.

Taxpayer contends that the Tax Court erroneously determined the nature of his business in finding that he was in the business of buying and selling candy for his

own account. He claims the evidence shows that his buying and selling activities were in connection with the procurement of candy for Kroger, and that he was a candy "broker." There is substantial evidence in the record to support the Tax Court on this issue and such findings are not clearly erroneous.

Taxpayer challenges many of the other findings as not being supported by substantial evidence, as clearly erroneous, and made in disregard of the evidence and absent proof of fraud by clear and convincing evidence. We have carefully examined all of these contentions and have considered the record as a whole, and have concluded that taxpayer's contentions are not well founded. It would serve no good purpose to burden this opinion with a detailed statement of these charges. The Tax Court has treated this matter rather fully in its Memorandum filed January 31, 1958, Docket No. 57280, its final decision being entered March 27, 1958. ..... T.C. .....

As was stated by the late Judge Lindley of this court in *Pleason* v. *Commissioner of Internal Revenue*, 7 Cir., 226 F. 2d 732, 733 (1955), it is for the trial court "to weigh the evidence, draw inferences and declare the result • • • [and] our only function is to determine whether the findings are clearly erroneous, that is whether upon the whole record, there is substantial evidence to support them and whether the court erred as to the law." See also, *Wisconsin Mem. Park Co.* v. *Commissioner of Internal Revenue*, 7 Cir., 255 F. 2d 751, 753 (1958), and Rule 52(a), Federal Rules of Civil Procedure, 28 U.S.C.A.

We reject taxpayer's contention that he has established that the Commissioner's determination of deficiencies in his taxes were arbitrary and excessive or based on a formula which could not produce the correct amount of tax due so as to bring this case within the rule laid down in *Helvering* v. *Taylor*, 293 U.S. 507 (1934). Absent such showing, the Commissioner's determination "has the support of a presumption of correctness, and the petitioner [taxpayer] has the burden of proving it to be wrong." *Welch* v. *Helvering*, 290 U.S. 111, 115 (1933); *Wisconsin Mem. Park Co.* v. *Commissioner of Interna*

Revenue, supra at 753. This does not mean that the Tax Court must agree with the Commissioner in all respects, and, in the instant case the Tax Court, under the evidence presented, did not feel bound to accept completely the Commissioner's determination and was not precluded from reducing the deficiencies as it did in a substantial amount. *Rogers* v. *Commissioner of Internal Revenue*, 7 Cir., 248 F. 2d 452, 453 (1957). The rule in *Helvering* v. *Taylor, supra,* does not prevent the Tax Court from exercising its function, in a proper case, of redetermining the deficiencies assessed by the Commissioner.

The Tax Court properly held that whatever overceiling payments had been made should be included in cost of goods sold in computing taxpayer's profits from sales, and credit was given accordingly. See *Sullenger* v. *Commissioner*, 11 T.C. 1076, 1077.

In determining the several categories of taxpayer's expenses or costs of sales, the Tax Court found that taxpayer failed to substantiate his claims beyond the point of proving their existence in part; and, consequently it properly made the best estimate it could from the evidence at hand in reliance upon the rule in *Cohan* v. *Commissioner*, 2 Cir., 39 F. 2d 540 (1930), as approved by us in *Pleason* v. *Commissioner of Internal Revenue*, 7 Cir., 226 F. 2d 732, 734 (1955). Deductions are a matter of legislative grace and "the burden is upon the taxpayer to establish the amount of a deduction claimed," *Helvering* v. *Taylor*, 293 U.S. 507, 514 (1934). This he failed to do.

There is no presumption of fraud and the Commissioner has the burden of proof with clear and convincing evidence. We have set out in some detail the Tax Court's findings on this issue. "Fraud is a question of fact, and the Tax Court finding is binding if it is supported by substantial evidence." *Bender* v. *Commissioner of Internal Revenue*, 7 Cir., 256 F. 2d 771, 774-775 (1958), and cases cited therein. We think there is substantial evidence in this record to support these findings of fraud by the Tax Court.

Finding no error in the disposition of this case by the Tax Court, the decision is

AFFIRMED.

UNITED STATES COURT OF APPEALS

FOR THE SEVENTH CIRCUIT

Friday February 20, 1959

Before

Hon. F. Ryan Duffy, Chief Judge

Hon. J. Earl Major, Circuit Judge

Hon. John S. Hastings, Circuit Judge

ROBERT F. ZEDDIES, *Petitioner,* v. COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	Petition for Review of a Decision of the Tax Court of the United States.

No. 12433

This cause came on to be heard on the transcript of the record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this Court that the decision of the Tax Court of the United States entered in this cause on March 27, 1958 be, and the same is hereby, AFFIRMED.

UNITED STATES COURT OF APPEALS

FOR THE SEVENTH CIRCUIT

Chicago 10, Illinois

Monday, March 30, 1959

Before

Hon. F. Ryan Duffy, Chief Judge

Hon. J. Earl Major, Circuit Judge

Hon. John S. Hastings, Circuit Judge

ROBERT F. ZEDDIES, *Petitioner,* v. COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	Petition for Review of a Decision of the Tax Court of the United States.

No. 12433

It is ordered by the Court that the petition for rehearing of this cause be, and the same is hereby, DENIED.

APPENDIX B.

Internal Revenue Code of 1939:

Sec. 54. RECORDS AND SPECIAL RETURNS.

(a) *By Taxpayer.*—Every person liable to any tax imposed by this chapter or for the collection thereof, shall keep such records, render under oath such statements, make such returns, and comply with such rules and regulations, as the Commissioner, with the approval of the Secretary, may from time to time prescribe.

* * * * *

(26 U.S.C. 1952 ed., Sec. 54)

Sec. 275. PERIOD OF LIMITATION UPON ASSESSMENT AND COLLECTION.

Except as provided in section 276—

(a) *General Rule.*—The amount of income taxes imposed by this chapter shall be assessed within three years after the return was filed, and no proceeding in court without assessment for the collection of such taxes shall be begun after the expiration of such period.

* * * * *

(26 U.S.C. 1952 ed., Sec. 275.)

Sec. 293. ADDITIONS TO THE TAX IN CASE OF DEFICIENCY.

* * * * *

(b) *Fraud.*—If any part of any deficiency is due to fraud with intent to evade tax, then 50 per centum of the total amount of the deficiency (in addition to such deficiency) shall be so assessed, collected, and paid, in lieu of the 50 per centum addition to the tax provided in section 3612 (d) (2).

(26 U.S.C. 1952 ed., Sec. 293.)

Internal Revenue Code of 1954:

Sec. 7454. BURDEN OF PROOF IN FRAUD AND TRANSFEREE CASES.

(a) *Fraud.*—In any proceeding involving the issue whether the petitioner has been guilty of fraud with intent to evade tax, the burden of proof in respect of such issue shall be upon the Secretary or his delegate.

* * * * *

(26 U.S.C. 1952 ed., Supp. II, Sec. 7454.)